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RUEATRS/DEPT OF TREASURY WASHINGTON DC
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RUCPDO/DEPT OF COMMERCE WASHINGTON DC
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RUEHKO/AMEMBASSY TOKYO 2434
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UNCLAS SECTION 01 OF 02 JAKARTA 001644

SIPDIS
SENSITIVE

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA/MALACHY NUGENT
COMMERCE FOR 4430/KELLY
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
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USTR WEISEL, EHLERS

E.O. 12598: N/A
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SUBJECT: CONFIDENCE LOW DESPITE STRONG Q2 GDP

REF: Jakarta 1487

11. (SBU) Summary. Indonesia's economy expanded a 6.4% in the second quarter of 2008, mainly on strong export and investment performance.

High prices, particularly in food commodities, continue to undermine the gains from faster economic growth. Indonesian confidence in the economy and government remain very low by historical standards, despite an increase in July. Government policies to offset the impact of rising prices on the poor exclude a large portion of the near poor community. End Summary.

GDP Growth Unexpectedly Strong

12. (U) Indonesia's GDP expanded 6.4% (yoy) during the second quarter, beating most market forecasts. Export growth remained strong in the second quarter, rising 16.1% (yoy), supported by high commodity prices. The prices of many commodities have declined significantly since that time, however, dampening the outlook for export growth in the second half of the year. Import growth remained robust, increasing 16.7% (yoy) during the second quarter. If import growth remains high and lower commodity prices hamper export growth, Indonesia may face slower growth and pressure on the Rupiah later this year, as the trade balance weakens.

13. (U) The pace of investment and domestic consumption remained strong in the second quarter, but decelerated from the previous quarter. Investment rose 12.8% (yoy) in the second quarter, down from 15.4% (yoy) in the first three months of the year. Growth in domestic consumption fell to 5.5% (yoy) in the second quarter, down from 5.7% in the previous quarter. A recent GOI report noted that the importance of domestic consumption to economic growth has declined this year, falling to 42% in the first half of the year, down from 52% in 2007.

14. (SBU) Credit growth continues to rise in Indonesia, indicating investment may remain strong during the rest of the year. Credit grew almost 35% (yoy) in July according to Bank Indonesia. The banking sector has largely balanced credit growth across consumption loans, working capital loans, and investment loans. While loan

growth has increased significantly over the past year, deposit growth has slowed, likely due to negative real interest rates (the inflation rate is now roughly 300 basis points above the overnight interest rate). If these trends persist, liquidity constraints could curb loan growth later this year. Moreover, rapid loan growth usually causes deterioration in loan quality, which could prompt more conservative loan practices moving forward.

High Food Prices Undermine Gains from Growth

15. (SBU) High food and overall prices continue to strain household budgets. Headline inflation rose to 11.9% (yoy) in July, driven in large part by a 19.9% (yoy) increase in the overall price of food (reftel). Food price increases continue to hit the lowest income groups, which spend roughly 60% of their incomes on food, the hardest. The price of rice, Indonesia's most important staple food, has stabilized in recent months, although the price is up 16.4% on a yoy basis. If the international price of rice, which also declined significantly in June and July, rises again before the end of the year (when Indonesia traditionally imports rice), domestic rice prices could rise again, hurting consumers. The current international price of rice is between \$550 and \$700, depending on the quality. World Bank economists believe that rice prices over \$700 per metric ton encourage smuggling out of Indonesia, putting additional pressure on domestic supply. While rice harvests in 2008 are not low by historic standards, the international rice market remains thinly traded and subject to significant volatility. According to rice market analysts, major buyers are currently waiting for lower prices, temporarily suppressing demand.

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16. (SBU) According to World Bank estimates, the rise in food prices in Indonesia has significantly undermined the positive impact of economic growth on poverty reduction. The official poverty rate fell to 15.4% in 2008, from 16.6% in 2007. However, according to World Bank estimates, the poverty rate would have been two percentage points (or 4.5 million people) lower in the absence of food price inflation. World Bank officials also estimate that every additional 10% increase in the price of rice in Indonesia not only erodes all gains from economic growth, but also increases the number of people living below the poverty line by as much as 2 million.

Food, Fuel, Jobs Remain Top Concerns

17. (U) Despite some improvement in July, consumer confidence and confidence in the government are at historic lows in Indonesia. Danareksa Research Institute's Consumer Confidence Index rebounded in July, most likely in response to the government's direct cash transfer program and steadier rice prices. However, the consumer confidence index, at 73, remains well below the 80 average level recorded in 2007. The key concerns of consumers are the price of basic foodstuffs, the price and scarcity of fuel, and the lack of jobs. Concern over each of these factors worsened from June to July in contrast to the overall trend. Consumer concern over general inflation declined significantly over the same period.

18. (SBU) Danareksa's confidence in government index also improved in July, but remains well below the level seen in 2007. The index dropped to 80 in June from over 100 in late 2007 before rebounding to roughly 82 last month. According to Danareksa analysts, a score of 100 or more is necessary for the current government to remain in power. The sharp decline in the index is almost entirely due to the high and volatile price of food and the scarcity of job opportunities. The other components of the index, namely the government's ability to maintain public safety, to support public infrastructure and to ensure legal certainty, remain at or near 100.

Government Policies Overlook Near Poor

19. (SBU) The Government of Indonesia's (GOI) policies to offset the impact of rising prices on the poor have succeeded for those receiving benefits, but the programs exclude a large portion of near

poor community. According to the World Bank, two of the government's largest pro-poor programs, the direct cash transfer program and the subsidized rice program, have been very effective in offsetting rising food and fuel prices for the 19 million poor households that receive benefits. However, the program entails considerable leakages. The means testing used to identify the 19 million households placed on the list of poor families is very labor intensive and subject to error. Because the list is static, it also misses many families that were just above the poverty line before the study, but have now fallen below that level, and retains families that have moved out of poverty. Economists believe the latter is a particular problem in Indonesia's outer islands, where economic growth has increased significantly in recent years. The GOI is planning to conduct an updated survey this year.

110. (SBU) More targeted pro-poor policies are difficult to implement in Indonesia, according to experts. Most economist feel large public works programs that provide low wage jobs are the best way to target poor households, as only individuals with true need apply to work. However, analysts and government officials have noted that these programs are often ineffective in Indonesia, as public officials divert large portions of the project's resources through corrupt practices.

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